

MEMORANDUM

August 27, 2004

TO: MSHDA Management Agents
FROM: Donna McMillan, Director Asset Management
SUBJECT: Revised Replacement Reserve Policy

Dear Management Agent:

Good news! We have updated the Replacement Reserve Policy. The revisions were primarily intended to clarify definitions and bring the policy in line with current practices. Most of the changes were issued previously in memos from former Asset Management Director, Patricia Lake. A focus group of management agents from the Michigan Housing Council were also consulted in wording the revisions.

Attached is a copy of the revised policy. Modifications have been highlighted in bold face Comic Sans type. The policy can be found at MSHDA's web site:
http://www.michigan.gov/mshda/0,1607,7-141-8002_28177-82957--,00.html.

If you have questions, please contact the asset manager assigned to your development.



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MICHIGAN STATE HOUSING DEVELOPMENT AUTHORITY
OFFICE OF ASSET MANAGEMENT**OPERATIONS MANUAL**

CHAPTER

Financial Analysis

SUBJECT

**REPLACEMENT RESERVE FEE
POLICY****SUMMARY:**

This policy provides guidelines for the use and requisition of Replacement Reserve funds.

REPLACEMENT RESERVE: PURPOSE - MSHDA's Regulatory Agreement requires the establishment and maintenance of a MSHDA-held Replacement Reserve fund. The Replacement Reserve fund is primarily designed to defray the cost of the replacement of major depreciable items provided for in the original mortgage.

CONTRIBUTIONS -- The minimum contribution amount for developments that have not had a Comprehensive Needs Assessment (CNA) is calculated by multiplying the Replacement Reserve factor (identified in the development's Regulatory Agreement) times the prior year's approved budgeted rent potential. Contributions to the Replacement Reserve are typically payable in monthly installments of a specified amount. Developments that have had a MSHDA-commissioned CNA are required to contribute to Replacement Reserve according to the CNA.

MSHDA will invest the Replacement Reserve funds in an interest-bearing account. All interest becomes part of the Replacement Reserve fund and is subject to the disbursement procedures described herein. The Replacement Reserve fund is an asset of the development and remains with the development upon any change in ownership.

Developments With CNAs: Developments that have a MSHDA-commissioned CNA are required to modify contributions to the Replacement Reserve according to the CNA. Funding status for each development's Replacement Reserve Escrow Account will be categorized as follows:

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- 1) Fully-Funded - Replacement Reserve Escrow Accounts are fully-funded when the CNA only has a Plan 1, or cash contributions have eliminated the deficit projected in the Plan 2. Owners of developments with over-funded Replacement Reserve accounts per the Plan 1 may request that escrow contributions be reduced. Or, disbursement may be requested for capital expenditures or amenities with prior MSHDA approval.
- 2) Adequately-Funded - Replacement Reserve Escrow Accounts are adequately funded when owners are making deposits in accordance with the CNA Plan 2, or a modified version of the Plan 2 approved by MSHDA.

NOTE: Developments with Replacement Reserve Needs per MSHDA monthly Mortgage Servicing statements are not adequately-funded;

- 3) Under-Funded - Owners of developments with under-funded Replacement Reserve Escrow Accounts are not making deposits at the levels needed to maintain a positive balance in the account for the mortgage term. Plan 2 will recommend a formula or plan for adequate funding. Adjustments to Plan 2 must be approved by MSHDA. Developments not able to fund Replacement Reserve to the required levels will have a Replacement Reserve Needs calculation reflected in their monthly Mortgage Servicing statements. Year-end surplus cash will be deposited in the Replacement Reserve account to reduce this deficit. Replacement Reserve Needs will be calculated as follows:

Contributions required per CNA or modified version

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approved by MSHDA

Less: Contributions actually made

Equals: Funding Deficit

ELIGIBILITY CRITERIA -- Each Replacement Reserve draw request must equal or exceed \$1,000. Each invoice in the draw request must be within 12 months of the date of the draw and each item included in the request must meet the eligibility criteria listed below. If items included in the draw request are determined to be ineligible, and this causes the total amount of the draw request to fall below \$1,000, the draw request will be denied and returned. Replacement items are eligible for Replacement Reserve reimbursement if **ALL** of the following conditions are met:

- All items eligible for reimbursement must be included in the CNA for those developments that have a CNA. Eligible items can be included in the draw if they are noted in the CNA as needing replacement within the next three years. A copy of the page(s) from the CNA must be included with the draw request. The requested items must be highlighted. **NOTE:** See "Exceptions".
- Items that are not generally due to deferred maintenance.
- No funds are available for the item out of the following alternative sources:
 - Insurance reimbursements;
 - Trade-in allowances;
 - Warranties;
 - Security deposit damage amounts, legally deductible from a residents deposit after all outstanding late charges and rent have been deducted; or
 - 236 Excess Income approved by HUD for specific use.
- The development has been in operation for five years unless replacement items are of an emergency nature; i.e. structural components. The first five years of development

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operation are defined as five years from the first day of the month following the cut-off date. (Exceptions may be specified in the Regulatory Agreement.)

- The development has an up-to-date Maintenance Source Data book.
- Items have exhausted the normal life expectancy.
- Cost for each item is reasonable and the item and it's installation meets minimum FHA and MSHDA standards.
- "Under- funded" developments (as defined on page 2) must meet the financial test outlined on Attachment B.

NOTE: Section 8 Preservation Pass-Through developments should use the financial test outlined on Attachment C.

The Financial Test for Replacement Reserve eligibility is waived for developments that meet one of the following three criteria:

1. The MSHDA-commissioned CNA Plan 1 indicates the Replacement Reserve account is "fully-funded" (as defined on page 1) throughout the remaining term of the MSHDA mortgage;
2. The Replacement Reserve account is "adequately-funded" as defined on page 2, item 2.
3. The Replacement Reserve account is funded above \$3,000 per unit and no MSHDA CNA has been completed.

LIST OF ELIGIBLE ITEMS -- The following is a list of eligible replacement items for those developments that have **not** had a MSHDA-commissioned CNA. For those developments that have a CNA, only items specifically listed in the CNA are eligible:

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- Antennas
- Appliances (Stove, Refrigerator, Washer/Dryer, Dishwasher, and Microwave)
- Asphalt
- Bathroom Fixtures (Vanity, Tub, Water Closet, and Medicine Cabinet)
- Boiler and Major Components
- Cabinets
- Carpet
- Carports
- Ceramic Tile
- Common Area Furnishings
- Chimney
- Concrete
- Counter Tops
- Doors and Hardware
- Eaves trough
- Elevator/Parts
- Emergency, Fire Protection, and Security Equipment
- Exhaust Fans
- Faucets
- Fence
- Garbage Disposals
- Handrails
- HVAC System and Major Components
- Light Fixtures
- **Painting – Exterior and Common Areas**
- Recreational Equipment
- Repaving
- Roofing
- Siding
- Signs
- Sinks
- Smoke Detectors
- Swimming Pool Repairs
- Tile/Linoleum/Sub Floors
- Trees and Foundation Plantings
- Wall covering
- Water Heater/Softener
- Windows/Screens
- Window Treatments (Blinds, Drapes, and Other

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Treatments)

NOTE: Labor to move furniture or appliances when installing floor coverings is an eligible Replacement Reserve expenses.

INELIGIBLE ITEMS - The following are some of the items that are not Replacement Reserve eligible:

- Stock items. All items must be installed to be eligible for reimbursement;
- Office equipment/computers and software;
- Lawn equipment;
- Trucks;
- New additions to the site.

EXCEPTIONS – MSHDA may make the following exceptions to the Replacement Reserve policy in an effort to keep mortgage payments current, or if the work relates to health, safety and welfare of the residents, or for other reasons agreed to by MSHDA:

- Approve a different Replacement Reserve escrow deposit amount;
- Defer Replacement Reserve escrow deposits;
- Approve Replacement Reserve disbursements for deferred maintenance or for minor replacement items; or
- Approve Replacement Reserve for items cited in MSHDA's annual physical inspection report.

NOTE: All requests for exceptions must have prior written Authority approval. Any capital improvement disbursement, deferred deposits, disbursements

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made in the first five years of operations, disbursements made for items not included in the CNA or for deferred maintenance and minor replacements shall be treated as a loan and must be repaid to the development to the Replacement Reserve account. The agent must sign a letter agreeing to repayment terms.

Also, if an exception is granted for an item **NOT** clearly Replacement Reserve eligible, **ALL** alternative financing sources must be exhausted prior to the use of the Replacement Reserve. **For exception items only**, the amount of Replacement Reserve that can be released is that amount that will bring the liquidity position to zero (does not protect one month's rent potential).

PRE-APPROVAL REQUESTS -- Pre-approval requests must include the Agent's Pre-approval Request Letter (Attachment E) and copies of three bids. If the selected bid is not the lowest bid, justification must be included. If less than three bids are submitted, an explanation must be included. Pre-approval is required for any single item expenditure exceeding \$10,000.

Note: Regardless of the funding source, if there is a substantial replacement of building components, a capital improvement or other major repair, a copy of material specification and brief description of the work to be completed must be sent to the assigned asset manager for prior approval. These approvals are required when using development held operating funds or MSHDA held escrows.

Pre-approval is not required to address emergency repairs or replacements that may affect health or safety. MSHDA must be notified that the expenditure has occurred. Reimbursements for emergency repairs and replacements are still subject to all other Replacement Reserve eligibility factors.

BID INFORMATION -- Bids for Replacement Reserve items must

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contain the following:

- Name and address of development;
- Name of insurance agency, if applicable;
- Building number(s) involved in bid, if applicable;
- Unit number and/or address where work is to be completed, if applicable;
- Description of the nature of work to be completed;
- Agent's description of the specifications on materials to be used;
- Specifications and total costs of materials/labor which the repair person proposes to use;
- Certification that the materials to be used as described above meet or exceed the FHA minimum property standards and/or MSHDA design standards;
- Name, address, city, state, and telephone number of bidder;
- Down payment terms, if applicable; and
- Signature of bidder.

DOWN PAYMENTS -- MSHDA may approve Replacement Reserve requests requiring a down payment, if the down payment request is documented by the contractor's bid.

ACCUMULATED REQUESTS -- In most circumstances it is appropriate to accumulate Replacement Reserve disbursements and submit them after the work has been completed. Accumulated requests can only include invoices from the previous 12 months and for which costs are reasonable as determined by MSHDA.

MAINTENANCE SOURCE BOOK -- The Mortgagor's Management Agent must maintain serial numbers and unit numbers in a

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Maintenance Source Book, which is kept on site. The Maintenance Source Book must contain the following:

- Item - Model/Type;
- Date warranty begins;
- Expiration date of warranty;
- Unit number of item;
- Replacement date;
- Source of item;
- Service contract - yes/no, expiration date.

NOTE: The Asset Manager will ensure that the Maintenance Source Book is maintained on site. Periodic checks will be conducted to ensure that the Agent updates the Maintenance Source Book.

OWNER/AGENT'S REPLACEMENT RESERVE REQUEST -The Owner/Agent must submit a written request to the assigned Asset Manager in order to receive Replacement Reserve funds. Each request must include the following:

- **Agent's Request Cover Letter** (Attachment A) certifying that the draw meets **ALL** of the eligibility criteria. **ANY** exceptions to the eligibility criteria must be explained.
- **Replacement Reserve Worksheet** (Attachment B or C).
- **Replacement Reserve Request Item Summary** (Attachment D).
- **Page(s) from the CNA** with the item(s) highlighted that are included on the Item Summary, where applicable.
- **Invoices for completed work** and Authority bid and/or pre- approval (if applicable).

PROCESSING -- The assigned Asset Manager will verify that the draw meets the eligibility and financial requirements. Disbursements

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are expected to be completed within 30 days of receipt by MSHDA. Processing may include an inspection of the completed work to determine the following:

- Replacement items meet or exceed minimum FHA and/or MSHDA Standards of Design;
- Costs are reasonable;
- The proposed or completed repairs will solve the problem.



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ATTACHMENT A

MANAGEMENT AGENT'S REQUEST COVER LETTER

Re:

Dear ASSET MANAGER:

We are requesting MSHDA's approval of a disbursement from the Replacement Reserve account in the amount of \$_____.

In connection with this request, the undersigned hereby certifies that:

1. The replacement item meets or exceeds minimum FHA standards and/or MSHDA design standards. Attached is MSHDA's original bid approval, if applicable.
2. Unless a MSHDA approved exception has been granted:
 - The item is a major depreciable item that is included in the CNA -or- the item is an eligible Replacement Reserve item as identified in MSHDA's Replacement Reserve Policy.
 - The total draw exceeds \$1,000.
 - The item was not replaced due to deferred maintenance.
 - The item has exhausted its normal life expectancy.
 - The development has been in operation for five years.
3. This Replacement Reserve request is not a duplicate.
4. A **Replacement Reserve Request Item Summary** (Attachment D) and invoices for the completed work are attached and all invoices are from the previous 12 months.
5. No alternative funding sources are available including insurance reimbursements, trade-in allowances, warranties, security deposits, or Section 236 Excess Income approved by HUD for an item(s) on the **Replacement Reserve Items Request Summary**.
6. This request meets one of the four financial criteria outlined on the **Replacement Reserve Worksheet** (Attachment B or C).

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7. For those developments that have a CNA, a copy of the page(s) from the CNA Capital Needs Worksheet is attached with the requested items highlighted.

(NOTE: Items not included in the CNA for which additional Replacement Reserve funds were escrowed should be noted as such in Attachment D.)

Sincerely,

(Agent)

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DEVELOPMENT NAME:

MSHDA NO:

This worksheet must be completed UNLESS the property meets one of the following exceptions:

EXCEPTIONS - Check If Applicable:

- ___ MSHDA-commissioned CNA indicates the Replacement Reserve Escrow is fully funded throughout the term of the mortgage commitment. Date of CNA: _____
- ___ MSHDA-commissioned CNA indicates the Replacement Reserve Escrow is adequately funded and owners are making deposits in accordance with the CNA Plan 2, or a modified version of the Plan 2 approved by MSHDA. Date of Approval: _____
- ___ Replacement Reserves funded above \$3,000 per unit and NO MSHDA CNA has been completed.

Information as of: _____ (Month and Year of MIE)

AVAILABLE DCE INTEREST (If No DCE, proceed to Item 4)

DCE Interest Balance

A. _____

DCE I Budgeted to Offset Deficits 1. _____

DCE I Budgeted for Capital Items 2. _____

Unpaid prior year cumulative L.D. 3. _____ (attach Schedule II)

SUM TOTAL (Lines 1 through 3)

B. _____

DCE I AVAILABLE (Line A minus B, enter 0 if negative)

C. _____

MAXIMUM REPLACEMENT RESERVE DRAW

One Month's Gross Rent Potential 4. _____

Significant Invoices dated after MIE 5. _____ (attach explanation)

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SUM TOTAL (Lines 4 and 5)

D. _____

Available DCE Interest (Line C)

6. _____

Liquidity Position

7. _____

Draws Approved but not deposited

8. _____

Excess Escrows (i.e. Tax Appeal, Ins Adj)

9. _____

SUM TOTAL (Lines 6 through 9)

E. _____

TOTAL POTENTIAL RESERVE DRAW (Line D Minus E) F. _____

REMEMBER, IF LINE E IS NEGATIVE YOU WILL BE SUBTRACTING A NEGATIVE NUMBER AND IN EFFECT MUST ADD LINES D AND E TO ARRIVE AT LINE F.

LINE F EQUALS THE MAXIMUM AMOUNT ELIGIBLE FOR REIMBURSEMENT FROM REPLACEMENT RESERVE. If Line F is less than \$1,000, Surplus Operating Cash is available and the Replacement Reserve request will be denied.

Asset Manager Signature: _____ Review Date: _____

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Section 8 Pass-Through Developments****Development Name:**
MSHDA #:

Information as of: _____ (Month and Year of MIE)

AVAILABLE DCE INTEREST (If No DCE, proceed to Item 4)

DCE Interest Balance

A. _____

DCE I Budgeted to Offset Deficits

1. _____

DCE I Budgeted for Capital Items

2. _____

Unpaid prior year cumulative L.D.

3. _____ (attach Schedule II)

SUM TOTAL (Lines 1 through 3)

B. _____

DCE I AVAILABLE (Line A minus B, enter 0 if negative)

C. _____

MAXIMUM REPLACEMENT RESERVE DRAW

One Month's Gross Rent Potential

4. \$ _____

L.D. Payment (One Year Maximum

5. \$ _____

Annual Premium Management Fee

6. \$ _____

Significant Invoices dated after MIE

7. \$ _____ (attach explanation)

SUM TOTAL (Lines 4 through 7)

D. \$ _____

Available DCE Interest (Line C)

8. \$ _____

Liquidity Position

9. \$ _____

Draws Approved but not deposited

10. \$ _____

Excess Escrows (i.e. Tax Appeal, Ins Adj)

11. \$ _____

SUM TOTAL (Lines 8 through 11)

E. \$ _____

TOTAL POTENTIAL RESERVE DRAW (Line D Minus E)

F. \$ _____

REMEMBER, IF LINE E IS NEGATIVE, YOU WILL BE SUBTRACTING A NEGATIVE NUMBER AND IN EFFECT MUST ADD LINES D AND E TO ARRIVE AT LINE F.

LINE F EQUALS THE MAXIMUM AMOUNT ELIGIBLE FOR REIMBURSEMENT FROM REPLACEMENT RESERVE. If Line F is less than \$1,000, Surplus Operating Cash is available. The Replacement Reserve request will be denied.

Asset Manager Signature: _____ Review Date: _____

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REPLACEMENT RESERVE FEE POLICY**ATTACHMENT D****REPLACEMENT RESERVE REQUEST ITEM SUMMARY**

DATE OF REQUEST:

DEVELOPMENT NAME:

MSHDA #:

ITEM DESCRIPTION	QUANTITY	INVOICE DATE	UNIT #	INVOICE AMOUNT
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TOTAL: -----

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REPLACEMENT RESERVE FEE POLICY**ATTACHMENT E****AGENT'S PRE-APPROVAL REQUEST**

Re:

Dear ASSET MANAGER:

We are requesting MSHDA's pre-approval for a disbursement from the Replacement Reserve account in the amount of \$_____.

In connection with this request, the undersigned hereby certifies that:

1. The replacement item will meet or exceed minimum FHA standards and/or MSHDA design standards.
2. The item is a major depreciable item that is included in the CNA -or- the item is an eligible Replacement Reserve item as identified in MSHDA's Replacement Reserve Policy.
4. The item is not being replaced due to deferred maintenance.
5. The item has exhausted its normal life expectancy.
6. The development has been in operation for five years.
7. This Replacement Reserve request is not a duplicate; no item contained herein has been previously reimbursed.
8. There are no alternative funding sources available including insurance reimbursements, trade-in allowances, warranties, security deposits or Section 236 Excess Income approved by HUD for a specific use.
9. The enclosed bids meet the criteria for the submission of bids as outlined in MSHDA's Replacement Reserve Policy.
10. For those developments that have a CNA, a copy of the page(s) from the CNA Capital Needs Worksheet is attached with the requested items highlighted.

(NOTE: Items not included in the CNA for which additional Replacement Reserve funds were escrowed should be noted as such in Attachment D.)

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It is understood that, upon completion of the work, we will submit a request for reimbursement from the Replacement Reserve. The draw must meet the financial requirements outlined in the Replacement Reserve Policy at the time the draw is submitted.

Sincerely,

(Agent)